Identifying Your Profitable and Unprofitable Customers

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Abstract
The focus of organizations on customer value has already got a great achievement in the past decade. The term valuable customer has already been recognized. But unprofitable customers have not caused great attention. Some managers even deny the existence of unprofitable customers. This paper first address the unprofitable customers, develops a framework for customer value management. The framework is organized around four continuously process: monitoring your customer purchase behavior, developing your own customer behavior database, analyzing customer value and identifying profitable/unprofitable customers, and taking actions. This paper discusses in detail how to assess customer value and identify profitable and unprofitable customers. Then, it addresses the practice action to each kind of customers.
Keywords: Customer Value, Profitable Customer, Unprofitable Customer, Customer Behavior

1. Introduction

The focus of organizations on customer value has already got a great achievement in the past decade. Both organizational managers and academic researchers realize the importance of customer service. While customers are the primary source of revenue, companies want to acquire more and more customers, namely enlarge their market share. However, does the company who has the biggest market share really can enjoy the highest profit? Unfortunately, the answer is definitely no. For example, Northwest Airlines is not the biggest organization within the U.S. airline market. Its domestic market share during the period of March 2007 to February 2008 is 6.7%, ranked 6[1]. But Northwest Airline earned $2,093 million in 2007 according to the report of 2008 FORTUNE 500, ranked 1[2].

Since pursuing the biggest market share is not a wise choice for each company, what should companies do? How to make every dime that invested bring more profit? Companies should pay much attention to their customer, construct their own customer information database, analysis their customer purchase behavior, calculate customers’ value, identify their profitable and unprofitable customers, and then make marketing decisions.

The concept of valuable customer has already been recognized in nowadays market, but unprofitable customer is a new word. No managers would like to admit the truth that there are lots of unprofitable customers in their company [3]. As Larry and Geoffrey said, executives always thought that all their products had positive gross margins, and the company managed inventories well, so tons of capital was not tied up. Thus, they reasoned, no matter what baskets of goods customers bought, they must all be profitable. But there are two aspects that managers forgot. First, they ignore the service cost, such as sales associate, electricity, and so on. Second, those unprofitable customers seize resources that should be given to profitable customers.

This paper develops a framework for customer value management. The framework is organized around four continuously process: monitoring your customer purchase behavior, developing your own customer behavior database, analyzing customer value and identifying profitable/unprofitable customers, and taking actions. Fig. 1 shows a broad overview of the framework of customer value management. The rest of this paper is structured as follow: Section Ⅱ presents the ways to monitor customer behavior and construct internal information database. The qualitative and quantitative customer value analysis method is discussed in Section Ⅲ. Different marketing actions which aimed at different kind of customers are introduced in Section Ⅳ. Concluding remarks and future research topics are outlined in Section Ⅴ.

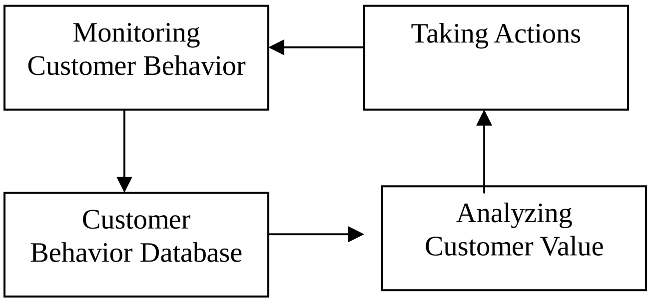

Figure1. Framework for customer value management

2. Customer Behavior and Customer Behavior Database

2.1 Customer Behavior

Knowing customer behavior is the first step to do the customers value management. Customer behavior is so complicated that each company should define which kinds of behavior will be added to its information system. By extension, customer behaviors to a particular company denote any contact that the customer has with the firm [4]. Jackson groups industrial buyers into two major categories: lost-for-good and always-a-share [5]. Jackson's categories are more useful to predict customer future purchase behavior. This paper is aim to analysis current behavior and found profitable and unprofitable customer, so we rely on another category which is on the point of purchase nature, including repeat purchases, cross-buying, or recommendations to others. These interactions can be customer initiated or firm initiated [6], and they can significantly influence firm's revenue stream [7]. Repeat purchase is the most obvious behavior that can increase firm's revenue, and it is also easy to record. Although cross-buying is not focus on one product, they also belong to the organization's product line. So it is also can be recorded. Recommendation or effect of Word-of-Mouth is still a big problem now. Researchers agree that it bring indirect revenue, and can be seen as customer value. But it is hard to calculate. Nobody can accurate evaluate the value of Word-of-Mouth. So this paper only focuses on customers' repeat purchases and cross-buying behavior.

After defined what kind of behavior should be recorded into the database, we also need to decide which detailed information should be included. Reach, Frequency, and monetary are the most common variable in customer lifetime value research field. According to RFM, company can calculate the current value within a period. Here we also suggest recording some demographic information so companies can also do some clustering analysis, and judge whether the new customer is worthy to obtain.

2.2 Customer Database

Enterprise information management is becoming more and more popular. Most of the companies have already bought software, such as CRM, ERP, and so on. There are two problems of the ways above to improve enterprise information management. First of all, most of the software are not customized. It can not be used directly, or can not play an effective role in real management. Second, CRM is great, but when everyone in the industry is doing the same things, all the companies are back to the same starting line. In a word, companies should develop their own information system, which can store customer data, and do relative analysis. We list some of the most important things below.

Who is your customer? Determining the appropriate unit of analysis is the most important thing [4]. In this paper, we just discuss the context of business to customer. For most of the personal product or service, the analysis unit should be individual customer, such as hair cut, clothing. For other companies, the analysis unit maybe means the each household, such as electronic equipment. Companies should define their customer according to the nature of their product or service.

How long is your product or service life cycle? When analyzing the customer value, we should decide a proper time period. Different product or services have different proper purchase frequency. For example, automobile company may calculate their customer value within the past 5 years, and Milk Company may only need to consider value in the past 3 month.

How to effectively collect your customers' data? Consumers are worried about that personal data would be compromised. So customer would not like to share their purchase information with the company. In that context, membership is a good method. For example, Kroger is a supermarket chain in the U.S. It is easy to become a Kroger's member. The only thing you need to do is filling in a form and it is totally free. Kroger members can enjoy a cheaper price for all the promotional products. You need to scan your membership card first when you check out. Customers would like to get cheaper products, and companies will get customers purchase information easily.

3. Customer Value Analysis

3.1 Qualitative Analysis

Companies with lots of unprofitable customers were actually spending money to bring in customers who were reducing the value of the firm [3]. When you have already got your customer purchase information, it is easy to identify your unprofitable customers. Those kinds of customers have the following characteristics.

Always buy products on sale. In order to enlarge cross-buying or reduce storage, companies put some products on sale. Products on sale are always less unprofitable or even none profitable. Customers who only buy products on sale are definitely unprofitable customer.

Fig.2. is an example of customer profitability matrix. Customers with high total purchase money mount and low percentage on sales are the most valuable customers. On the contrary, customers with low total purchase but high percentage on sales are unprofitable customers.

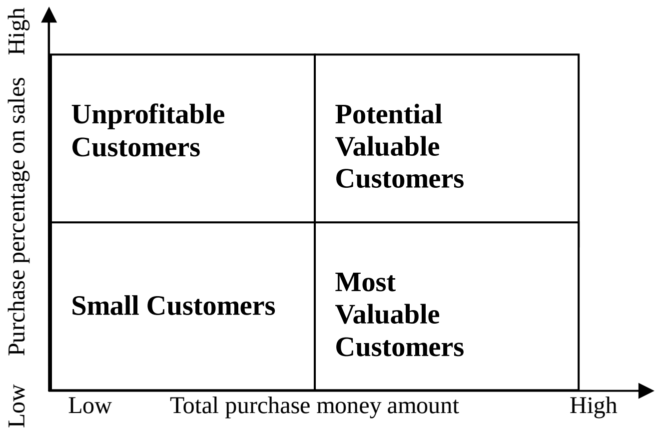

Figure 2. Customer profitability matrix

Always return products. In this competitive market, more and more companies provide unconditional return service. When you found some customer has a high return rate, they should be viewed as unprofitable customers. On the one hand, when something was returned to the company, the original revenue was also returned to customer. On the other hand, most of the returned products can not be sold on a regular price. Finally, it also increase the service cost.

Take full advantage of free service policy. Some customers do a lot of research on company's service policy, such as free parking, one time health examination in birthday month. Customers who deal in micrograms are more likely to be unprofitable ones.

Maintaining such unprofitable customers is really a nightmare for each company. Companies will not get profit from them. Some even screwed the value that created by other customers.

3.2 Quantitative Analysis

The term customer value can be understood in two ways [4]. In this paper, customer value means the "value that the customer provides to the firm", instead of the "value provided by the firm to the customer" [8].

Kotler and Armstrong define a profitable customer as "a person, household, or company whose revenues over time exceed, by an acceptable amount, the company costs of attracting, selling, and servicing that customer." [9].

In general, customer value equals to net present value of customer purchase minus net present value of company cost on acquiring and maintaining this customer.

Customer Value (CV) = Net present value of customer purchase - Net present value of company cost (1)

Typical data for each customer within a time period can be depicted as in Fig.3. Within the observation period T, a customer joins the firm and gets n times purchase. Each time he spends \$xi (i=1, 2,…, n), and each purchase between time ti (i=1, 2,…, n). In the meanwhile, the company invests \$ma (a=1, 2,…, T/t) to maintain the customer. d is the yearly discount rate (appropriate for marketing investments).

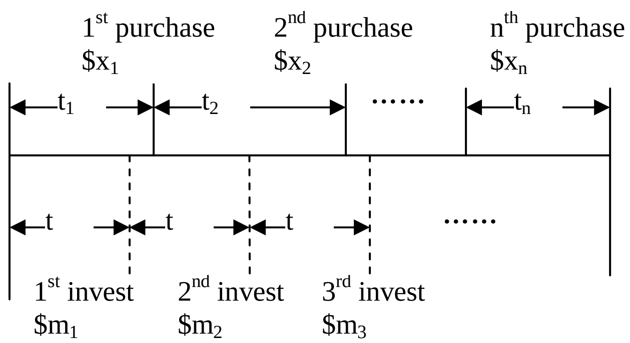

Figure 3. Typical Customer purchase cash flows

In the above case,

$$CV = \sum_{i=1}^{n}[x_i/(1+d)^{q_i}] - \sum_{a=1}^{T/t}[m_a/(1+d)^{p_a}]$$

$$q_i = \begin{cases} \sum_{i=1}^{i} t_i \quad (when \sum_{i=1}^{i} t_i > 1year) \\ \sum_{i=1}^{i} t_i/12\,(when \sum_{i=1}^{i} t_i < 1year) \end{cases}$$

$$p_a = \begin{cases} at \quad (when, at > 1year) \\ at/12\,(when, at < 1year) \end{cases} \qquad (2)$$

Numerical example. Suppose that the company pays \$ 50 per customer yearly. An appropriate discount rate for marketing activities is 20%. In the past 3 years, one customer makes her first purchase of $ 80 in the first year, and makes her second purchase of $200 in the 3rd year. Then,

$$CV = 80/(1+0.2) + 200/(1+0.2)^3 - 50/(1+0.2) - 50/(1+0.2)^2 - 50/(1+0.2)^3 = \$77.08$$

4. Marketing Actions

According to the 3 steps mentioned above, companies will calculate out his customer value. Then, they can identify their most valuable customer and unprofitable customer precisely.

4.1 Maintain the Most Valuable Customers

Believe it or not, it is entirely typical to find that just the best 20% of a company's customers generate a huge portion of its share price- in some cases, all of it [3]. Since managers have already found out their most valuable customers. Company should allocate the scarce resource to most valuable customer, improve the service quality, and enhance the relationship between the company and valuable customers.

Further study in valuable customer history data, summarize their purchase behavior and find out more potential business opportunity.

Further investigate within valuable customers. Better meet their needs, improve their satisfaction and form customer loyalty.

4.2 Let Your Unprofitable Customer Go

Managers are not philanthropist, they can not let unprofitable customer leave in the organization. There are some methods to let them go.

Stop sending promotion advertise to those customers. If they can not receive the sale information, the frequency of purchase may be dropped, and the chance of they come to grab other valuable customers' recourse will definitely reduced.

Increase their waiting time. Managers should keep a list of unprofitable customers. When they called in for a help, companies can just put them in a long waiting line which may make them impatience and leave the company.

4.3 Change Unprofitable Customer Into Profitable Customer

Change marketing promotion strategy. Stop using the discount strategy. Bundled selling is one of the wise skills. If you want to buy something at a lower price, you also need to buy another thing. "Buy one gets on free" is also a better promotion strategy than direct discount. When companies changed their promotion method, unprofitable customers will change their purchase behavior. They may adapted themselves to the new policy, and become profitable customers. Otherwise, they may leave the company, and the companies become more profitable without them.

Let them use self-service system. Self-service can greatly reduced the cost. If the unprofitable customers switched to lower-cost channels, they became profitable.

4.4 Conclusion and Suggestions for Future Research

In customer management, customer value is the most important indictor. This paper proposes a framework for customer value management. Within the new framework, this article stresses the concept of unprofitable customer, discusses in detail how to assess customer value and identify profitable and unprofitable customers and gives the customer value calculation equation. In our view, this frame work is a starting point for enterprises' own customer management system. It is a good tool for enterprises practical management.

Due to the time and ability limited, there is no Empirical study in this paper. In the future, further verification study will be done as well as the development of enterprise information system. In addition, some cluster analysis also can be done in the future. According to the result of cluster analysis, companies can find their customer segmentation, draft different customer strategy to different segment. However, much more work remains to be done.

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